NO. 21671

IN THE UNITED STATES COURT OF APPEALS

FOR THE NINTH CIRCUIT

ACIFIC GRAINS, INC.,

Appellant,

v.

OMMISSIONER OF INTERNAL
EVENUE,

Appellee.

APPELLANT'S BRIEF

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MISCELLANEOUS

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APPELLANT'S BRIEF

Appeal from the Tax Court of the United States

STATEMENT OF JURISDICTION

This is an appeal from the decision of the Tax Court of he United States affirming the determination of the Commissioner f Internal Revenue which asserts for the fiscal years ending anuary 31, 1963 and January 31, 1964, Federal income tax eficiencies against Appellant in the respective amounts of 5,850 and $12,408.06. If Appellant was entitled to deduct as business expense all compensation paid to Mr. Robert R. Rodgers, ppellant's president, in excess of $30,000, the amount determined o be unreasonable by the Tax Court, there is no deficiency for he years here involved. Appellate jurisdiction and venue are ranted this Court by 26 U.S.C.A., Sec. 7482(a) and 7482(b)(1).

The Tax Court had the jurisdiction by virtue of 26 U.S.C.A. Sec. 7442.

STATEMENT OF THE CASE

Pacific Grains, Inc., an Oregon corporation formed on February 19, 1955, has its principal office in Rickreall, Oregon. Pacific Grains, Inc. (hereinafter referred to as "petitioner") filed Federal income tax returns for the fiscal years ending January 31, 1963 and January 31, 1964, the years here involved, with the District Director of Internal Revenue for the District of Oregon.

Petitioner is entitled to a business deduction of the compensation paid to Robert R. Rodgers, provided such compensation was a reasonable allowance as set forth in Section 162 (a)(1). The Tax Court held that the compensation paid in excess of $30,000 was not reasonable.

There is no controversy concerning the facts set forth below. They are either direct, or substantially direct, quotations from the stipulation and Tax Court findings, or are based upon uncontradicted testimony. The transcript of the record consists of two volumes. Volume I containing the stipulation of the parties, the exhibits, all of which were joint exhibits of the parties under the stipulation, and the Tax Court memorandum findings of fact and opinion is hereinafter referred to as "R". Volume II containing the report of the proceedings before the Tax Court is hereinafter referred to as "Tr".

Mr. Rodgers is president and principal officer of

titioner and the owner of all the presently outstanding ock in Petitioner. (R 16, Stip. para. 5). The full attention Mr. Rodgers is directed toward Appellant (Tr 18).

Mr. Rodgers came to Oregon in 1946 at the age of 26 years ortly after being separated from the Armed Forces following rld War II. He began work at Derry Warehouse Co., a grain evator company, near Rickreall, Oregon, and by 1952 had come manager thereof. He served as manager of the company ring 1952, 1953, and 1954, but at no time did he own stock this company. (R 19, Stip. para. 13).

Along with his long time friend, Wayne R. Giesy, he ft Derry Warehouse Co. and with Mr. Giesy formed Petitioner February, 1955, "with its principal assets being a grain evator in Rickreall, Oregon, which had a capacity of proximately 300,000 bushels". Later in the same year, titioner built another elevator at Suver, Oregon, with a pacity of 50,000 bushels. Petitioner "commenced operations terally 'across the street' from Derry Warehouse and directly mpeted with Derry Warehouse." (R 19, Stip. para. 13).

Upon formation of Petitioner, Mr. Rodgers became esident and treasurer of the corporation and Mr. Giesy came vice president. In February of 1959, Mr. Giesy sold s stock to Mr. Rodgers, and Mr. Rodgers took over the duties eviously performed by Mr. Giesy in addition to his own. (R , Stip. para. 7).

Petitioner was started with Mr. Rodgers and Mr. Giesy rrowing approximately $30,000 in cash, and with this money

hey purchased the stock of Petitioner (Tr 15-6). From this eginning, Petitioner has grown to the point that the net orth of the corporation was $119,090.26 for the fiscal year nding January 31, 1963 and $140,784.91 for the fiscal year nding January 31, 1964 (R 74). These net worth figures differ omewhat from the net worth figures shown on the tax returns or these years by reason of the non-reflection on the books f the company of the special tax deduction for emergency mortization of grain facilities (Tr 29).

During the years here involved Petitioner had an overall nvestment in grain storage facilities of approximately 260,000 in 1963 and $340,000 in 1964 (R 17, Stip. para. 6) nd an overall investment in grains and grass seeds of $207,331 n January 31, 1963 (R 33) and $403,367 on January 31, 1964 R 43).

In the initial stage of formation, Petitioner was engaged n the operation of grain elevators and a warehouse. The peration of the warehouse was to buy grain and seed from the armers, process the same by cleaning and bagging and then elling the end product. (Tr 16).

Due to the instigation of the soil bank and diversified eed grain programs of 1961 by the Federal government, ubstantial amounts of acreage were removed from production nd thereby storage income from the elevators was reduced. To ffset this reduction Petitioner entered into the trading of rass seed on a world-wide basis. (R 18, Stip. para. 8) By eason of this trading on a world-wide basis the corporate

ales increased significantly despite the decrease in acreage roduction in the local area (R 18 Stip. para. 9), and the axable income was increased to a new corporate high in each f the subsequent years (R 72).

.For the fiscal years here involved the sales from trading epresented approximately .85% of the gross income with the emaining 15% being earned from grain storage and cleaning perations (R 17, Stip. para. 6). Almost all the income for he years here involved was attributable to the trading perations (Tr 17-8, 39).

Trading is a highly competitive and speculative operation nd its success is almost entirely dependent upon the abilities f the trader (Tr 18-20). One serious error of judgment in the uying and selling on the fast fluctuating market could leave he trader's firm in a very precarious position (R 18, Stip. ara. 8). The mortality among businesses in such operations is igh. Mr. Rodgers testified that there was in the past years three or four in the West Willamette Valley that had gone out f business and several of them by the bankruptcy route". (Tr 19)

Mr. Rodgers does all the trading for Petitioner (Tr 18). n this position, constant devotion to and study of weather and rop conditions throughout the world is required (R 18, Stip. ara. 8). Due to the varying time differentials around the orld, Mr. Rodgers has received telephone calls dealing with he business of Petitioner at all hours of the day and night R 18, Stip. para. 10), and usually must devote about twelve ours a day to the operations of the Petitioner (Tr 18). Other

than a possible business convention, Mr. Rodgers has not taken a vacation in the last eight years (Tr 25).

Mr. Rodgers is highly thought of by others in the trading business and has a reputation of being highly competent. Mr. Dave Lees, an employee of a competitor of Petitioner, testified that Mr. Rodgers was "real competent and is a good trader and his contracts are good. His integrity is above reproach and he does a lot of business". (Tr 41) Mr. William K. Wiley, another competitor, testified that Mr. Rodgers' reputation is excellent", and he is "well thought of" and "very competent" (Tr 54).

In addition to doing all the trading, Mr. Rodgers was also ultimately responsible for the other operations of Petitioner, including the grain elevators. The Petitioner has "roughly half a dozen" permanent employees and during the summer months an additional forty to fifty employees are hired to help in the operation of the grain elevators (Tr 20).

For the fiscal year ended January 31, 1963, Mr. Rodgers was paid a compensation of $41,250 and for the fiscal year ended January 31, 1964, a compensation of $55,200 (R 17, Stip. para. 5). For the same period Petitioner paid its other two principal employees an aggregate of $18,785.20 for the fiscal year ended January 31, 1963, and $27,281.20 for the fiscal year ended January 31, 1964. (R 19, Stip. para. 11). Part of the compensation paid to Mr. Rodgers and Petitioner's other principal employees was in the form of a bonus paid at the end of each of the years, a practice which Petitioner had followed in prior

ears. (R 17, 19, Stip. para. 5, 11).

For the nine years from Petitioner's formation through
he years here involved, the compensation paid to its officers
nd its taxable income are as follows (R 72):

al Year	Compensation Paid to Mr. Giesy	Compensation Paid to Mr. Rodgers	Total Compensation Paid to Officers	Taxable Income
31, 1956	$ 2,100.00	$ 2,100.00	$ 4,200.00	$ 2,452.67
31, 1957	5,400.00	6,300.00	11,700.00	13,116.65
31, 1958	13,600.00	17,200.00	30,800.00	13,045.01
31, 1959	6,600.00	10,700.00	17,300.00	(14,104.72)
31, 1960	_____	22,000.00	22,000.00	4,713.14
31, 1961	_____	22,000.00	22,000.00	(16,338.48)
31, 1962	_____	29,000.00	29,000.00	24,681.67
31, 1963	_____	41,250.00	41,250.00	26,362.78
31, 1964	_____	55,200.00	55,200.00	34,630.25

he average annual compensation received by Mr. Rodgers from
titioner for the above nine-year period was approximately
2,860.

The average annual compensation received by Mr. Rodgers
r the three years he was employed as manager of Derry Warehouse
., a corporation in which he owned no stock, was significantly
excess of the average annual compensation he received from
titioner for the above nine-year period. Mr. Rodgers received
r his duties as manager an average annual compensation of
6,050 per year from Derry Warehouse Co. (Tr 28). His duties
manager required of him only a forty-hour work week and no par-
cipation in trading operations (Tr 23).

In the early years of Petitioner, Mr. Rodgers testified that
paid himself less than he was worth so that the earnings would
left in the corporation thereby enabling Petitioner to grow
r 21). Mr. Giesy also testified that they did not intend the

ompensation to represent the value of their services because hey wanted to build up the business (Tr 57).

Mr. Dave Lees testified that his compensation was omparable to the compensation received by Mr. Rodgers from etitioner for the fiscal years ending January 31, 1963 and anuary 31, 1964 (Tr 46-7). The corporation for which Mr. Lees orks is in competition with Petitioner, and Mr. Lees serves s its president. The corporation is engaged in the trading f grain, seed and commodities with Mr. Lees making all of the rading decisions (Tr 40-1, 45, 48). Mr. Lees testified that the perations of his corporation were comparable to those of etitioner with the exception that his corporation operated o grain elevators (Tr 41).

Mr. Lees further testified that the compensation paid to r. Rodgers in view of the Petitioner's net profits was not nusual (Tr 46), and that "I know of competitors whose compen- ation is about the same as Mr. Rodgers'" (Tr 45). He also xplained that in the trading business if a man does a good job nd he asks for more money and the firm is making more money, e is given more money (Tr 45).

Mr. William Wiley, whose business is comparable in the ajor respects to the trading operations of Petitioner, also estified that his compensation was comparable to the compen- ation received by Mr. Rodgers for the fiscal year here involved Tr 54).

Mr. Rodgers testified that he did not believe he was verpaid by the compensation he received for services rendered

n the fiscal years ending January 31, 1963 and January 31, 964 (Tr 21-2).

The testimony of Mr. Rodgers is corroborated by the vidence of the annual rate of return on the invested capital f petitioner. The annual rate of return on the invested apital (capital plus retained earnings) of petitioner after the eduction of Mr. Rodgers' compensation and Federal income taxes ere as follows for the first nine years of petitioner's perations, the average return being 18.92 per cent (R 74):

Fiscal Year Ended	Percentages of Return
1/31/56	15.18%
1/31/57	14.10%
1/31/58	43.94%
1/31/59	13.09%
1/31/60	30.27%
1/31/61	2.35%
1/31/62	20.42%
1/31/63	15.57%
1/31/64	15.41%

Mr. Harold Brevig, the certified public accountant for titioner, testified that he did accounting work for other local mpanies that could be considered comparable to Petitioner and at he determined by computation that not one of these other ients had a higher rate of return on invested capital (Tr 34). . Brevig explained that the local companies to which he referred re primarily in the trading business like the Petitioner and at trading was at least as large a part of their business as was of the Petitioner's business (Tr 35).

The average annual return among the five hundred largest rporations in the United States was 10.5% for 1964 and 9.1% for 63 (Tr 31-2). The average annual return over a nine-year

eriod for eight large corporations which were somewhat comparable
o Petitioner were 4.3%, 7.15%, 13.27% 10.85%, 8.93%, 5.60%,
2.62%, and 10.0% (Tr 33-4)

SPECIFICATIONS OF ERROR

Petitioner contends the Tax Court of the United States erred as follows:

1. In not recognizing the economic realities which negate the adverse inferences drawn by the Court.
2. In considering only the compensation paid during the years at issue without taking into account the full picture.
3. In holding it was not bound by the uncontradicted and unimpeached testimony of Mr. Lees and Mr. Wiley.
4. In refusing to admit into evidence the testimony of Mr. Lees concerning his opinion of the reasonableness of the compensation paid by Pacific Grain, Inc. to Mr. Rodgers.
5. In failing to recognize and to be bound by the testimony of Mr. Rodgers that the compensation paid to him by Pacific Grains, Inc. for the fiscal years ending January 31, 1963 and January 31, 1964 was reasonable.
6. In holding that the evidence concerning the rate of return on the invested capital of Pacific Grains, Inc. for the fiscal years ending January 31, 1963 and January 31, 1964 was of scant value.
7. In holding that Pacific Grains, Inc. had failed to meet its burden of proof and that the determination of the Commissioner must be sustained.

SUMMARY OF ARGUMENT

As confirmed by the Commissioner in his Regulations, determination of reasonableness of compensation paid for a particular year should take into account all the compensation paid to the employee, including compensation for prior years. If total, aggregate compensation paid to the employee through the last year at issue is reasonable for all services rendered by the employee to the end of such year, no portion of the compensation is unreasonable.

Mr. Rodgers' employment as President of Petitioner covers a span of nine years commencing with the formation of Petitioner in February, 1955, continuing through the last year here involved (January 31, 1964). The aggregate compensation paid Mr. Rodgers over such nine year period averaged $22,860.00 per year.

In the usual reasonable compensation case, there is no prior employment record of the subject individual to throw light upon the value of his services. Then, for want of something better, compensation paid others in comparable positions must be utilized as the primary basis of determination. The instant case is unique in this respect.

efore forming Petitioner in February, 1955, Mr. Rodgers as manager of Derry Warehouse Co., a grain elevator company ear Rickreall, Oregon. It is stipulated that Petitioner, ith Mr. Rodgers as President, " . . . commenced operations iterally 'across the street' from Derry Warehouse and dir-ctly competed with Derry Warehouse".

When a person follows the aggressive American radition of quitting his job to open a competing business cross the street, the compensation received by such ndividual from his prior employer should have a significant earing upon the worth of his services to the new business, articularly where (as here) the competition is successful to uch an extent that the business realizes a remarkable 15% fter-tax return on invested capital despite payment of the ompensation alleged to be excessive. A person capable of uch accomplishments should be worth compensation equal to hat he would have received from his former employer if he had ontinued for a similar period of time at the average rate of ompensation paid by the former employer. During the three ears Mr. Rodgers worked as manager of Derry Warehouse Co., is compensation averaged $26,050.00 per year. This is sub-tantially more than the $22,860.00 per year average of the ompensation paid Mr. Rodgers by Petitioner through the last ear at issue.

The Tax Court ignores the conclusive impact of the oregoing and focuses attention on the fact that the $41,250.00 nd $55,200.00 paid by Petitioner to Mr. Rodgers as compensation or the fiscal years ending January 31, 1963 and January 31,

anuary 31, 1962. Unable to find satisfactory evidence that uch "dramatic jumps" were justified by increased duties and esponsibilities on the part of Mr. Rodgers during the fiscal ears ended January 31, 1963 and 1964 over the duties and res- onsibilities during the fiscal year ended January 31, 1962, he Tax Court concludes that the increases were intended as istributions of earnings rather than compensation for services endered.

The "dramatic jumps" in Mr. Rodgers' compensation are ttributable to economic motivation furnished by the corporate ax structure whereunder Congress, in recognition of the finan- ial difficulties faced by small corporations, taxes the first 25,000.00 of corporate taxable income at a substantially lower ate than taxable income over $25,000.00. While a corporation s under the $25,000.00 taxable income level, compensation for- bearance by the controlling stockholder results in corporate retention of 70¢ after taxes per each dollar not paid as com- pensation. Mr. Rodgers acquiesced in receipt of less than reasonable compensation during the years that his forbearance generated 70¢ after-tax dollars to Petitioner. The situation changed when taxable income of Petitioner reached $25,000.00, as it did for the years at issue. Then, compensation forbear- ance would have left the corporation with only 48¢ after taxes per dollar not paid as compensation.

Nothing in the tax law requires that a corporation pay reasonable compensation to its controlling officer- stockholder. It is perfectly legitimate to pay less than reasonable compensation when the savings resulting therefrom

ncrease corporate surplus by 70¢ after taxes per each etained dollar. Such underpayment does not preclude the aking up for past underpayments when taxable income exceeds 25,000.00 leaving the corporation with only 48¢ after taxes er each dollar not paid in compensation. This is precisely hat Congress encouraged by creating a difference in tax ates on corporate taxable income under $25,000.00 and tax- ble income over $25,000.00.

The important thing is not the erratic compensation attern motivated by tax considerations, but the question is hether the total, aggregate compensation paid over the full pan of years through the last year at issue is reasonable for he total services performed during such years. As set forth bove, the aggregate compensation paid Mr. Rodgers by Petitioner rom the time of its formation in February, 1955 through anuary 31, 1964, was less than the amount Mr. Rodgers would ave received during the same period of years if he continued ith Derry Warehouse Co., earning compensation at the same verage rate received during the three years he was manager of erry Warehouse Co.

By emphasizing the foregoing unique feature of this ase, Petitioner does not concede that the compensation paid r. Rodgers for the fiscal years ended January 31, 1963, and anuary 31, 1964, was unreasonable if judged on the basis of hose years alone. Substantial evidence presented by etitioner sustains the reasonableness of such compensation ithout taking into account the under payments in prior years.

Mr. Lees and Mr. Wiley, who occupy comparable
ositions in the trading business, each testified that his
ompensation was comparable to the compensation received by
r. Rodgers for the years here involved. Mr. Lees further
estified that Mr. Rodgers' compensation in relation to the
et profits of Petitioner was not unusual and that he knew of
ther men in comparable positions in the trading business
hose compensation was also about the same as that of Mr.
odgers. Since this testimony was uncontradicted and
nimpeached, the Tax Court was required by the rule of this
ourt to follow such testimony with its strong inference of
he reasonableness of the compensation paid to Mr. Rodgers.

Mr. Rodgers, himself, testified that the compensa-
ion paid to him for the years here involved was reasonable.
he Commissioner did not attempt to impeach this testimony
r present any testimony or other evidence to the contrary.
his evidence the Tax Court was also required to consider and
ollow under the rule of this Court.

Petitioner established by stipulated facts that for
he years here involved, it had a return on invested capital
capital plus retained earnings) of over 15% after payment of
r. Rodgers' compensation and Federal income taxes. Such a
eturn, according to the Petitioner's certified public
ccountant, was as great as any of his other clients which
ere comparable to the Petitioner and was far greater than
he average return earned by the 500 largest corporations in
he United States. This evidence being uncontradicted and
nimpeached, the Tax Court could not arbitrarily ignore such
vidence which showed an after-tax return of over 15% on

nvested capital as a most satisfactory return. Since income an only be earned through the use of capital or labor and ince the invested capital of petitioner was being most satis- actorily compensated for its use, the Tax Court should have ecognized that Mr. Rodgers was not being paid more than a easonable compensation for his services during the years here nvolved.

Despite the foregoing evidence and evidence of the ubstantial skill, hard work and heavy responsibility required f Mr. Rodgers in his duties for Petitioner, the Tax Court held hat the Petitioner had not overcome its burden of proof. bviously, the Petitioner's evidence was such that the ommissioner's determination could have been found inaccurate, nd so the presumption of correctness in favor of the ommissioner's determination disappeared. With the disappear- nce of the presumption, the Tax Court was required to render ts decision only on the basis of the evidence presented.

Aside from the evidence of the Petitioner, the Tax ourt could only look to certain stipulated facts which the ommissioner asserted gave the impression that part of the ompensation for the years here involved looked like disguised ividends. However, when these facts are viewed within the ontext of this case, the inference does not readily follow rom these stipulated facts, and a far more logical explan- tion appears which in no way indicates either disguised ividends or unreasonable compensation. Having no evidence,

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Despite the foregoing evidence and evidence of the ubstantial skill, hard work and heavy responsibility required f Mr. Rodgers in his duties for Petitioner, the Tax Court held hat the Petitioner had not overcome its burden of proof. bviously, the Petitioner's evidence was such that the ommissioner's determination could have been found inaccurate, nd so the presumption of correctness in favor of the ommissioner's determination disappeared. With the disappearnce of the presumption, the Tax Court was required to render ts decision only on the basis of the evidence presented.

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r at the most only a dubious inference, to consider in ddition to the significant and substantial evidence presented y the Petitioner, the Tax Court was clearly erroneous in hold- ng that the Petitioner had failed to meet its burden of proof. he Tax Court cannot substitute its own innate conception of easonableness in place of the significant and substantial vidence to the contrary.

r at the most only a dubious inference, to consider in addition to the significant and substantial evidence presented y the Petitioner, the Tax Court was clearly erroneous in holding that the Petitioner had failed to meet its burden of proof. he Tax Court cannot substitute its own innate conception of easonableness in place of the significant and substantial vidence to the contrary.

FIRST SPECIFICATION OF ERROR

The Tax Court erred in not recognizing the economic realities which negate the adverse inferences drawn by the Court.

ARGUMENT

The primary fact relied on by the Tax Court is that the $41,250 and $55,200 paid by Petitioner to Mr. Rodgers as compensation for the fiscal years ended January 31, 1963 and January 31, 1964, respectively, substantially exceeded the $29,000 in compensation paid to Mr. Rodgers for the fiscal year ended January 31, 1962. Unable to find satisfactory evidence that such "dramatic jumps" were justified by increased duties and responsibilities on the part of Mr. Rodgers during the fiscal years ended January 31, 1963 and 1964 over the duties and responsibilities during the fiscal year ended January 31, 1962,[1] the Tax Court concludes that the increases were intended as distributions of earnings rather than compensation for services rendered.

While the Tax Court uses the $29,000 paid for the fiscal year ended January 31, 1962 as a basis for the determination that "jumps" in the two subsequent years were intended as

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1 The Tax Court so found despite the fact that the dollar volume of sales for the fiscal year ended January 31, 1964 had increased by 34 per cent over the dollar volume of sales for the fiscal year ended January 31, 1962 (R 18, Stip. para 9). Most of such increase coming from the trading by Mr. Rodgers in grass seed on a world-wide basis (R 18, Stip. para. 8).

istributions of earnings, the Tax Court fails to point out that he $29,000 constituted a $7,000 jump over the $22,000 paid uring each of the prior fiscal years ended January 31, 1960 nd 1961. The same economic factors which motivated the 7,000 jump to $29,000 also motivated the subsequent jumps o $41,250 and $55,200. The fiscal year ended January 31, 1962 as the first year of Petitioner's existence when the taxable orporate income would have exceeded $25,000 at the then revailing rate of Rodgers' compensation. Whether corporate axable income is less than $25,000 or more than $25,000 has ignificance. Under the corporate tax structure in existence or many years, corporate taxable income under $25,000 has been axed at a lesser rate than taxable income over $25,000. For he years here involved, corporate taxable income under $25,000 as taxed at 30% and corporate taxable income in excess of $25,000 as subject to an additional surtax of 22%, making a total tax f 52% on corporate taxable income over $25,000. The Revenue ct of 1964[2] applicable to taxable years beginning after ecember 31, 1963 reduced corporate taxes, and the explanatory ommittee reports contain the following significant statement:

> "The 'reversal' of the corporate rates should be a substantial benefit to small business. The substitution of a 22-percent rate for the 30-percent rate represents a rate reduction of nearly 27 percent on the first $25,000 of income, as contrasted to the rate reduction for above $25,000 of slightly less than 8 percent...

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2 78 Stat. 19 (1964)

> "Your committee believes that it is important to provide a greater rate reduction for small businesses because of their importance in maintaining competitive prices in our economy, and also because of the greater difficulty small businesses have in finding outside funds to finance their expansion. As a result they have traditionally found it necessary to expand largely out of income remaining after tax."[3]

his makes it clear that the lower corporate tax on the first 25,000 of taxable income is intended as an encouragement to mall business for the purpose of enabling them to accumulate fter-tax income, a thing to be fostered because small usinesses are important in maintaining competitive prices in ur economy.

While the difference in tax rates applicable to income nder $25,000 and income over $25,000 is greater under the evenue Act of 1964 than under the Act applicable to the years ere at issue, there was nonetheless a 22% difference between he tax rates applicable to Petitioner's taxable income under 25,000 and taxable income over $25,000. Such a tax structure urnishes strong motivation for a small corporation to do hatever it can to build up the first $25,000 of net annual ncome. An obvious way to control taxable corporate income s through the amount of compensation paid controlling stock- olders. Forbearance of a controlling stockholder in taking ompensation when the corporation is under the $25,000 income evel will leave the corporation with 70¢ out of each dollar

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3 H. R. Rep. No. 749, 88th. Cong., 1st Sess. 27 (1963); . Rep. No. 830, 88th. Cong., 2d Sess. (1964).

ıot paid as compensation. When corporate taxable income
:xceeds the $25,000 level, each dollar of compensation
'orbearance leaves the corporation with only 48¢ after taxes.
:t is much easier to forbear taking deserved compensation
'hen the reward to the corporation is 70¢ after-tax dollars
han when the reward is only 48¢ after-tax dollars.

As stated by this Court in the recent case of Murphy
ıogging Co. v. United States, (9th Cir. May 15, 1967) 67-1
.S.T.C. Par. 9461:

> "...Tax reduction is not evil if you do not do it evilly. Often an inefficient operator, wise as to taxes, can do better than an efficient operator who is stupid about his taxes."

n Commissioner v. Brown, 380 U.S. 563, 579-80 (1965) affirming
decision of this Court, Justice Harlan's concurring opinion
elates:

> "...the tax laws exist as an economic reality in the business man's world, much like the existence of a competitor. Businessmen plan their affairs around both and a tax dollars is just as real as one derived from any other source."

etitioner and Mr. Rodgers would have been stupid and oblivious
o economic reality if they had not responded to the Congressional
ncouragement afforded small corporations in building up after-
ax dollars at the preferential rate applicable to corporate
axable income under $25,000.

It is no mere coincidence that the $7,000 compensation
ncrease given Mr. Rodgers for the fiscal year ended January

1, 1962 reduced Petitioner's taxable income to $24,681.67 hich is about as close to $25,000 as one can come since onuses are declared just prior to the end of the fiscal year n the basis of tentative figures. The Commissioner has never omplained about the amount of compensation paid to Mr. Rodgers or the fiscal year ended January 31, 1962. The same motivation nfluenced the amount of compensation paid to Mr. Rodgers in ubsequent years. The $41,250 for the fiscal year ended January 1, 1963 reduced Petitioner's taxable income to $26,362.78 and he $55,200 paid to Mr. Rodgers for the fiscal year ended anuary 31, 1964 reduced Petitioner's taxable income to $34,630.25.

Nothing in the tax law requires that a corporation pay easonable compensation to its controlling officer-stockholders. t is perfectly legitimate to pay less than reasonable ompensation when the savings resulting therefrom increases orporate surplus by 70¢ after taxes per each retained dollar. his does not preclude the payment of reasonable compensation, r even the making up for past underpayments,[4] in subsequent ears when corporate taxable income exceeds $25,000 and ompensation forbearance would leave the corporation with only 8¢ after-tax dollars. As indicated by the above quotation rom the committee's reports, this is precisely what Congress ntended by creating a difference in tax rates on net income ver $25,000 and net income under $25,000. The stated reason

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[4] See Lucas v. Ox Fibre Brush Co., 281 U.S. 115, 119 1930)

hy Congress expended the benefit to small business was the ecognized importance of such business in "maintaining ompetitive prices in our economy". Petitioner certainly satis- ied this expectation through its competition with Derry Ware- ouse Co. and others, and through its trading activities.

It is quite ironic that the efforts of Petitioner to ake advantage of a Congressional concession to small businesses reated the situation which resulted in the assessment of an 18,258.06 deficiency. Such deficiency is approximately 17% f the retained earnings which Petitioner laboriously ccumulated from its formation in February 1955 through January 964. What cries of anguish would evolve if a large competitor f Petitioner were deprived of 17% of its retained earnings. omehow, the Commissioner and the Tax Court expect Petitioner o absorb this loss and still fulfill the Congressional desire f affording effective competition. Also ironic is the reason iven by the Tax Court for sustaining the deficiency - that the lisallowed compensation was intended as a distribution of arnings. It is perfectly ridiculous to say that Petitioner ntended to distribute earnings during the years ended January 31, 1963 and 1964 when the immediately preceding year was the irst time Petitioner reached the $25,000 level. In the above uotation from the committee reports, Congress recognized that mall corporations under the $25,000 per year level "...have

traditionally found it necessary to expend largely out of income remaining after taxes". Congressionally recognized necessity of small corporations to rely upon retained income after taxes for expansion militates against judicial inference that a small corporation, such as Petitioner, intendes a distribution of earnings. Upon reaching the $25,000 level, a small corporation may reward its president by paying reasonable compensation for current services, and even make up for past forbearances, because the corporation is spending 48¢ after-tax dollars rather than 70¢ after-tax dollars. It defies reality, however, to conclude solely from a jump in compensation made by a corporation when it begins spending 48¢ dollars that a distribution of earnings rather than compensation was intended.

While the above related economic realities explain Petitioner's erratic compensation pattern thereby negating the adverse inference drawn by the Tax Court, the following questions remain: (i) should the prior years when Petitioner underpaid Rodgers be considered in determining the reasonableness of Rodgers' compensation for the subject years, and (ii) did Petitioner over-respond to the new experience of spending 48¢ rather than 70¢ dollars?

SECOND SPECIFICATION OF ERROR

The Tax Court erred in considering only the compensation paid during the years at issue without taking into account the full picture.

ARGUMENT

When a person's employment covers a span of years, reasonableness of compensation for one or two years cannot be determined without taking into account the services rendered and the compensation paid for all of the years. This self-evident proposition is recognized by the Commissioner in the following extract from his Regulations:[5]

> "...What constitutes a reasonable allowance [for compensation for services rendered] depends upon the facts in the particular case. Among the elements to be considered in determining this are the personal services actually rendered in prior years as well as the current year and all compensation and contributions paid to or for such employee in prior years as well as in the current year. Thus, a contribution which is in the nature of additional compensation for services performed in prior years may be deductible even if the total of such contributions and other compensation for the current year would be in excess of reasonable compensation for services performed in the current year, provided that such total plus all compensation and contributions paid to or for such employee in prior years represents a reasonable allowance for all services rendered by the employee by the end of the current year." (Emphasis added)

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5 Treas. Reg. Sec. 1.404(a)-1(b). While the Regulation is under Section 404 dealing with deduction of employer contributions to an employee's trust or annuity plan and compensation under deferred payment plans, the above quoted portion of the regulation applies to all compensation, not merely contributions under Section 404(a). In accord are the following cases which consider the reasonable compensation issue: Ernest Burwell, Inc. v. United States, 113 F. Supp. 26, 30 (W. D. S. Car. 1953); Jewel Ridge Coal Sales Co., Inc. 16 CCH Tax Ct. Mem. 140, 143 (1957).

Mr. Rodgers' period of employment as President and principal officer commenced with the formation of Petitioner in February 1955 and covers a period of nine years through the last fiscal year here involved. Set forth below is the compensation paid by Petitioner to Mr. Rodgers during these years:

Fiscal Year Ended January 31,	Total Compensation Including Bonuses
1956	$ 2,100.00
1957	6,300.00
1958	17,200.00
1959	10,700.00
1960	22,000.00
1961	22,000.00
1962	29,000.00
1963	41,250.00
1964	55,200.00

The above aggregate compensation averages $22,860 per year.

How does $22,860 per year compare with the earning power of Mr. Rodgers before coming with Petitioner? For the three years prior to forming Petitioner, Mr. Rodgers was manager of Derry Warehouse Co., a grain elevator company near Eckreall, Oregon in which he owned no stock (R 19, Stip. para. 3). During these years Derry Warehouse Co. paid Mr. Rodgers an average annual compensation of $26,050 (Tr 28). Such demonstrated ability to earn $26,050 in the competitive business world without benefit of control over the employer has significance even if there were no similarity between the two jobs. Petitioner could not have enticed Mr. Rodgers away from

erry Warehouse Co. in an arm's length transaction without ssuring him that low compensation in the company's formative ears would be made up in the future, so that his compensation ver a reasonable future time would average at least the $26,050 e was then making. Nine years is longer than a reasonable ime. How can any portion of compensation averaging less than 26,050 in nine years be deemed unreasonable?

If comparability between the business of Derry Warehouse o. and the business of Petitioner is necessary before ertinency can be accorded Mr. Rodgers earning $26,050 per ear from Derry Warehouse Co. under arm's length conditions, uch comparability is established by the below quotations from he stipulation:

> "In 1952 Mr. Rodgers was made the manager of Derry Warehouse Co., a grain elevator company near Rickreall, Oregon. ...When Messrs. Rodgers and Giesy left Derry Warehouse, they formed Pacific Grains, Inc. in February 1955, and commenced operations literally 'across the street' from Derry Warehouse and directly competed with Derry Warehouse." (R 19, Stip. para. 13) emphasis added.

irect competition between two companies in the same business, cross the road from each other, indicates a certain amount of omparability. More important than comparability is the fact hat Petitioner headed by Mr. Rodgers was successful in the ompetition. Why is it unreasonable for Petitioner to pay to r. Rodgers average annual compensation less than the amount reviously paid Mr. Rodgers by Petitioner's arch competitor?

In the ordinary "reasonable compensation" case, the amount paid "A" for job "X" is used to establish the reasonableness of the amount paid "B" for job "Y". Naturally, there must be a demonstrated equivalency between job "X" and "Y" for the comparison to make any sense. A completely different situation is presented when "A" and "B" are the same person. Then the algebraic formula starts with a known identity, and the demonstrated ability of "A" to make so many dollars in job "X" should go a long way toward supporting the reasonableness of paying "A" the same dollars to leave job "X" and take job "Y", regardless of similarity between jobs "X" and "Y". All doubt is resolved concerning the reasonableness of compensation in such a situation if job "Y" is competitive with "X", and "A"s performance of job "Y" results in successful competition.

The Tax Court attaches no significance to Mr. Rodgers' employment by Derry Warehouse Co. at $26,050 per year because the Court found a lack of comparability between the business of Petitioner during the years here involved and the business of Derry Warehouse Co. when Mr. Rodgers was manager. Any such differences are attributable to a change in corporate direction of Petitioner instigated by Mr. Rodgers to overcome an adverse economic development, as related in the following substantially direct quotation from the stipulation:

> In 1961 the Federal Government's soil bank programs resulted in the removal from production of substantial acreage in petitioner's area. To

> off-set the loss of storage income, Rodgers decided to become active in trading grass seed on a world-wide basis. This was a highly speculative venture, and a serious error in judgment would have been financially disastrous to the company. Constant devotion and study to weather and crop conditions throughout the world was required. Despite the decrease in acreage and production in the area, petitioner increased its sales volume. (R 18, Stip, para. 8-9)

change in corporate direction which successfully copes th an adverse economic development enhances the value of e president's services. Moreover, Mr. Rodgers was required accept far more responsibility, to exert far more skill d to work far more hours than required by his duties as nager for Derry Warehouse Co.

Another reason given by the Tax Court for ignoring mpensation paid to Mr. Rodgers in prior years is that the rporate resolutions authorizing the bonuses for the years ded January 31, 1963 and 1964 failed to "...indicate such nuses were intended as compensation for services rendered him in prior years" (R 82). Nothing in the above quotation rom Treas. Reg. Sec. 1.404(a)-1 or any reported case[6] ndicates that amounts paid during prior years are taken into count only when corporate resolutions expressly state the

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6 See, e.g., Ernest Burwell, Inc. v. United States, pra note 5, at 30; Jewel Ridge Coal Sales Co., Inc., supra te 5, at 143.

mounts are intended as compensation for preceding years. he full picture is taken into account unless something xpressly limits compensation for a particular year to the ervices performed during that year alone.[7] There is no such imitation in the instant resolutions. Furthermore, Mr. Rodgers nequivocally testified that there was no intent in the rior years to pay him compensation commensurate with his orth (Tr 21). This uncontradicted testimony was corroborated y that of Mr. Giesy. (Tr 57)

Numerous tests have been devised by the courts to easure the reasonableness of corporate compensation paid o a controlling stockholder. The basic objective of uch tests is to ascertain what compensation would have volved from arm's length bargaining, i.e., what would the orporation have been required to pay if it were not controlled y the recipient. In the present case the answer to this ltimate question is readily apparent without applying ny of these tests. Simulation is unnecessary in the resence of actuality. Obviously, Mr. Rodgers could not

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7 Even if the compensation was limited to the ervices performed during that year alone, the underpayment n prior years still would not be excluded from consideration. s observed by the court in Commercial Iron Works v. ommissioner, 166 F.2d 221, 224 (5th Cir. 1948) it is reasonable usiness practice "for an employer to recognize and reward acrifices made by employees in hard, formative days by ranting a more generous compensation in the days that are ush."

have been enticed away from Derry Warehouse Co. by another corporation in which he owned no stock unless he was assured that within a reasonable time in the future his compensation from the other corporation would aggregate an amount at least equal to what he could expect if he stayed with Derry Warehouse Co. at the $26,050 per year then being paid him. It might not be reasonable for Mr. Rodgers to insist upon receiving in the aggregate what he would have received from Derry Warehouse Co. if he had failed to produce for Petitioner. However, Mr. Rodgers produced for Petitioner, as evidenced by the steadily increased retained earnings, a fact which even the Tax Court recognized. Since the aggregate compensation paid to Mr. Rodgers by Petitioner for the nine year period through January 31, 1964 was less than what Mr. Rodgers would have received from Derry Warehouse Co. at $26,050 per year, none of the compensation paid him through January 31, 1964 could have been unreasonable. This is Petitioner's irrefutable proposition which makes it unnecessary to determine whether Mr. Rodgers and the corroborating witnesses were correct in their belief that the compensation paid Mr. Rodgers for the years at issue was reasonable when judged on the basis of those years alone.

THIRD SPECIFICATION OF ERROR

The Tax Court erred in holding it was not bound by the uncontradicted and unimpeached testimony of Mr. Lees and Mr. Wiley.

ARGUMENT

Mr. Lees, an employee in a comparable position with a corporation which was in competition with Petitioner and comparable in all respects to the Petitioner except that unlike the Petitioner it did not operate any grain elevators, testified that his compensation was comparable to the compensation received by Mr. Rodgers from the Petitioner for the fiscal years here involved (Tr 40-1, 45-8). Mr. Lees further testified that in view of Petitioner's net profits such compensation was not unusual (Tr 46) and that he knew of other men in comparable positions in the trading business whose compensation was about the same as Mr. Rodgers' (Tr 45).

Mr. Wiley, whose business is comparable in its major respects to the trading operations of the Petitioner, also testified that his compensation was comparable to the compensation received by Mr. Rodgers from the Petitioner for the fiscal years here involved (Tr 53-5).

Comparableness of the compensation received by others occupying comparable positions in the same business has long been one of the most important criterion for determination of

easonableness. However, the Tax Court arbitrarily ignored he above testimony holding itself not bound thereby even hough uncontradicted and unimpeached and proceeded to deter- ine the question without assistance of evidence although the ax Court was devoid of knowledge and experience in this area. n so holding the Tax Court was in error.

The Tax Court cited as the authority for its position olden Construction Co. v. Commissioner, 228 F2d. 637 (10th. ir. 1955). In Golden Construction Co. v. Commissioner, supra t 639, the taxpayer had introduced opinion testimony of everal witnesses to the effect that the compensation paid was easonable and the Commissioner had introduced testimony of a itness, who was in a comparable position in a comparable usiness in the same industry, that his salary and that of the ther officers of the company were less than that paid to tax- ayer's employee. The Court held that the Tax Court could eigh the conflicting evidence as it saw fit and did not have o accept the opinion testimony over that of the Commissioner's itness. However, there was no conflicting evidence regarding he reasonableness of Mr. Rodgers' compensation in the present ase, and if the rule of Golden Construction Co. is as asserted y the Tax Court in the present case, it is clearly contrary

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8 See, e.g., Builders Steel Co. v. Commissioner, 197 F.2d 63, 265 (8th Cir. 1952); Patton v. Commissioner, 168 F.2d 28, 1, (6th Cir. 1948); Treas. Reg. § 1.162-7(b) (3).

ɔ the weight of the authority as well as the rule of

ıis Court. In Grace Bros. v. Commissioner, 173 F.2d 170,

74 (9th Cir. 1949), this Court declared:

> "It is axiomatic that uncontradicted testimony must be followd. [Citations] The only exception to the rule occurs when we are dealing with testimony by witnesses who stand impeached and whose testimony is contradicted by the testimony of others or by physical or other facts actually proved or with testimony which is inherently improbable."

ıe rule was reiterated by this Court in Anaheim Union Water

ɔ. v. Commissioner, 321 F.2d 253, 260 (9th Cir. 1963):

> "The testimony as to the fair market value of the water being uncontradicted and unimpeached, it was not permissible to assume a value at variance with the testimony."

In support of its holding in Anaheim Union Water Co.

. Commissioner, supra, this Court cited as authority Loesch

Green Construction Co. v. Commissioner, 211 F.2d 210 (6th

ir. 1954). In Loesch & Green Construction Co., as in the

resent case, the Tax Court had ignored the uncontradicted

nd unimpeached testimony concerning the reasonableness of

ıe compensation paid. In reversing the Tax Court, the

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9 See, e.g., Banks v. Commissioner, 322 F.2d 530, 37 (8th Cir. 1963); Erie Stone Company v. United States,)4 F.2d 331, 348 (6th Cir. 1962); Gordon v. Commissioner 68 F.2d 105, 107 (3d Cir. 1959); Indalantic, Inc. v. ɔmmissioner, 216 F.2d 203, 205 (6th Cir. 1954)

10 See, e.g., Anaheim Union Water Company v. ɔmmissioner, 321 F.2d 253, 260 (9th Cir. 1963); Grace Bros. . Commissioner, 173 F.2d 170, 174 (9th Cir. 1949).

ixth Circuit declared:

> "Their testimony was unimpeached and should have been accepted by the Tax Court in a matter in which it had no knowledge or experience upon which it could exercise independent judgment; and such evidence cannot be arbitrarily disregarded. ...Where unimpeached, competent and relevant testimony on behalf of a taxpayer is uncontradicted, it may not be arbitrarily discredited and disregarded, and the Tax Court cannot reject or ignore this evidence and determine the propriety of the amount of salaries paid upon its own innate conception of reasonableness." Id. at 212. [11]

The Commissioner in the present case presented no estimony or other evidence to contradict the witnesses. either of the witnesses were impeached and their veracity was n no way questioned by the Tax Court. Therefore, since the ax Court had no knowledge or experience upon which it could xercise an independent judgment, the testimony of both Mr. Lees nd Mr. Wiley was binding on the Tax Court. Mr. Lees and r. Wiley both having testified to the comparableness of r. Rodgers' compensation, the Tax Court was required to accept uch evidence with its strong inference of reasonableness.

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11 Accord, Indialantic, Inc. v. Commissioner, supra ote 9, at 205: "This court has repeatedly held that the ax Court is not authorized to disregard uncontradicted estimony concerning the worth and the reasonableness of ervices rendered. The value of the services is unquestioned nd the decision of the Tax Court ignores the undisputed acts."

FOURTH SPECIFICATION OF ERROR

The Tax Court erred in refusing to admit into evidence the testimony of Mr. Lees concerning his opinion of the reasonableness of the compensation paid by Pacific Grain, Inc. to Mr. Rodgers.

ARGUMENT

Petitioner attempted at the time of trial to introduce opinion testimony of Mr. Lees as to the reasonableness of the compensation paid by Petitioner to Mr. Rodgers. The Tax Court held, however, that it did not want Mr. Lees' opinion and that he could not testify as to his opinion of the reasonableness of Mr. Rodgers' compensation since he was not an expert (Tr 42-4, fully set forth in Appendix "A"). In so holding the Tax Court was in error.

The Courts have long allowed and accepted opinion testimony concerning the reasonableness of compensation.[12] The only expertise required of the witness is that he be familiar with the particular trade or business in the local area, with the taxpayer in his operations, and with the capabilities and work of the employee whose compensation is in question.[13] The testimony of Mr. Lees clearly depicts this

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12 See, e.g., Loesch & Green Construction Co. v. Commissioner, 211 F.2d 210, 211-212 (6th Cir. 1954); R. F. Farnsworth & Co., Inc. v. Commissioner, 203 F.2d 490, 492 (5th Cir. 1953); Idaho Livestock Auction, Inc. v. United States, 187 F. Supp. 875, 879 (E. D. Idaho 1960); Jewel Ridge Coal Sales Co., Inc., 16 CCH Tax Ct. Mem. 140, 143 (1957).

13 Ibid.

miliarity and thus his competence to testify concerning
s opinion of the reasonableness of the compensation paid to
. Rodgers (Tr 40-8).

The Tax Court had no experience or knowledge of its
n as to the reasonableness of salaries paid in the trading
siness. Thus, the opinion of reasonable compensation from a
mpetent witness in the trading business was of value. The
x Court should have therefore admitted and considered the
inion testimony of Mr. Lees.[14]

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14 See, e.g., Loesch & Green Construction Co. v.
mmissioner, supra note 12 at 211-12.

FIFTH SPECIFICATION OF ERROR

The Tax Court erred in failing to recognize and to be ound by the testimony of Mr. Rodgers that the compensation aid to him by Pacific Grains, Inc. for the fiscal years nding January 31, 1963 and January 31, 1964 was reasonable.

ARGUMENT

While the Tax Court did not permit Mr. Lees to testify s to his opinion of the reasonableness of the compensation aid to Mr. Rodgers, it did allow Mr. Rodgers to do so. r. Rodgers testified that he did not believe his compensation or the years here involved to be unreasonable (Tr 21-22). his testimony the Tax Court completely ignored and failed o consider in rendering its decision. In so doing, the ax Court erred.

No one was in a better position to know what was easonable compensation than Mr. Rodgers and he testified hat the compensation was reasonable.[15] As observed by the ourt in Gordy Tire Co. v. United States, 296 F.2d 476, 479 Ct. Cl. 1961).

> "Even people with an interest in the nature of their testimony are expected to tell the truth, and must be presumed to have done so, unless the contrary appears".

he integrity of Mr. Rodgers is above reproach (Tr 411). he Commissioner did not attempt to discredit such testimony

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15 Gordy Tire Co. v. United States, 296 F.2d 476, 478 Ct. Cl. 1961)

n cross-examination and did not present any direct testimony
r other evidence showing the compensation to be unreasonable.
he testimony of Mr. Rodgers should have therefore been
onsidered by the Court.

Since the Tax Court was required to consider the
estimony and since the testimony was uncontradicted and
nimpeached, the Tax Court was bound by this testimony to find
hat the compensation was reasonable,[16] especially in view of
he other substantial evidence presented by the Petitioner.
t is of no consequence that the testimony is of an interested
ather than a disinterested party.[17] Admittedly, such testimony
s not the most satisfactory, but as was already discussed
he Tax Court erroneously excluded the corroborating testimony
hich Petitioner had intended to present. Moreover, if the
ompensation was unreasonable in the present case, the
ommissioner should have been able to produce at least one
itness that could have so testified.

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16 See, e.g., Anaheim Union Water Co. v. Commissioner, upra note 10, at 260; Grace Bros. v. Commissioner, supra note 0 at 174. See generally, discussion at pp. supra.

17 See e.g., Ansley v. Commissioner, 217 F.2d 252, 56-257 (3rd. Cir. 1954); A. & A. Tool & Supply Co. v. ommissioner, 182 F.2d 300, 303-04 (10th. Cir. 1950).

SIXTH SPECIFICATION OF ERROR

The Tax Court erred in holding that the evidence concerning the rate of return on the invested capital of Pacific Grains, Inc. for the fiscal years ending January 31, 1963 and January 31, 1964 was of scant value.

ARGUMENT

The rate of return on invested capital (capital plus retained earnings) has long been recognized as an important criterion by the Courts[18] and the Internal Revenue Service,[19] and in recent Court of Claims cases the rate of return on invested capital has played a vital role in the determination of reasonable compensation.[20] The rate of return on invested capital is important because income can only be earned through the use of capital or labor. Therefore, if the capital is being satisfactorily compensated for its use, a very strong inference arises that labor is not being unreasonably

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18 See, e.g., Olympia Veneer Co., 22 B.T.A. 892, 906-07 (1931) acq. X-2 Cum. Bull. 53; Benz Brothers Co., 20 B.T.A. 1214, 1222 (1930) acq. X-1 Cum. Bull. 6; The Law and Credit Co., 5 B.T.A. 57, 60 (1926) acq. VI-I Cum. Bull. 4.

19 See, e.g., A.R.R. 53, 2 Cum. Bull. 110 (1920).

20 See, e.g., Boyd Construction Co. v. United States, 339 F.2d 620,624 (Ct. Cl. 1964); Bringwald, Inc. v. United States, 334 F.2d 639,642,644 (Ct. Cl. 1964); Gordy Tire Co. v. United States, 296 F.2d 476, 478-79 (Ct. Cl. 1961).

ompensated for its efforts in producing the income.

In the present case, Petitioner established by tipulated facts and uncontradicted testimony that Petitioner ad received a highly satisfactory rate of return from its nvested capital. It was stipulated that Petitioner had a eturn on invested capital of 15.57% and 15.41% for the espective years here involved after payment of Mr. Rodgers' ompensation and Federal income taxes (R 74). It was also tipulated that Petitioner had an average rate of return n invested capital for the first nine years of 18.92% (R 74). hese figures are substantially above the national average of he five hundred largest corporations, which was 9.1% and 0.5% for the respective years here involved, as well as bove the average return on invested capital of eight large orporations which were somewhat comparable to Petitioner Tr 32-4).

Mr. Brevig, the certified public accountant for etitioner, testified that he did accounting work for ther local companies that could be considered comparable to etitioner and that he determined by computation that not ne of these other clients had a higher rate of return on nvested capital (Tr. 34). Mr. Brevig explained that the ocal companies to which he referred were primarily in the rading business like the Petitioner and that trading was

t least as large a part of their business as it was of the etitioner's business. (Tr 35) The Commissioner did not iscredit such testimony on cross-examination and did not resent any testimony or other evidence to show the contrary.

The Tax Court, however, held the above testimony and tipulated facts to be of "scant value" on the basis that etitioner did not make its comparison with comparable ompanies (R 81-2). In so holding, the Tax Court completely gnored the testimony of Mr. Brevig that comparable local rading firms had no greater return on invested capital than etitioner and the fact that in only three fiscal years has etitioner had a better rate of return than the 15.57% and 5.41% for the years here involved. Being uncontradicted nd unimpeached, the Tax Court could not arbitrarily disregard uch evidence.[21]

Comparableness or no comparableness, it is hard to see ow an after-tax return on invested capital of over 15% can be aid to be less than highly satisfactory.[22] Whether one looks to ne rate of return for the five hundred largest corporations r for the trading firms in the local area, a rate of over 5% is a most satisfactory return. With the Commissioner

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21 See, e.g., Anaheim Union Water Company v. Commissioner, upra note 10, at 260; Grace Bros. v. Commissioner, supra note), at 174. See generally, discussion at pp. 36-8, supra.

22 A return on invested capital of over 15% compares uite favorably with returns of 5.8% and 8.8% which the court n Gordy Tire Co. v. United States, supra note 20, at 479, found o be satisfactory.

resenting no testimony or other evidence to the contrary, he Tax Court was required to find that the invested capital n Petitioner was being satisfactorily compensated for its use nd that by reason thereof a very strong inference arises that r. Rodgers was not being paid more than a reasonable compensa- ion for his services during the years here involved.

SEVENTH SPECIFICATION OF ERROR

The Tax Court erred in holding that Pacific Grains, c. had failed to meet its burden of proof and that the de- rmination of the Commissioner must be sustained.

ARGUMENT

The Tax Court held that the Petitioner had failed to et its burden of proof and thus the determination of the mmissioner must be sustained. The Tax Court so held spite the introduction of uncontradicted and unimpeached idence showing:

(1) That substantial skill, hard work and heavy responsibility was required of Mr. Rodgers and that the Petitioner was heavily dependent thereon,

(2) That in the opinion of Mr. Rodgers the compensation paid to him was reasonable,

(3) That Mr. Rodgers' compensation was comparable to the compensation paid others in comparable positions in the trading business,

(4) That Petitioner had underpaid Mr. Rodgers in prior years and had from the time of its forma- tion through the years here involved paid him an average annual compensation of only $22,860,

(5) That for the three years immediately prior to his employment with Petitioner, Mr. Rodgers had received an average annual compen- sation of $26,050 from one of Petitioner's

competitors, Derry Warehouse Co., a company in which Mr. Rodgers held no stock, and that his duties for Derry Warehouse Co. required far less skill, work and responsibility than his present duties for Petitioner,

(6) That the invested capital in Petitioner was highly compensated for its use in the years here involved, which very strongly infers that Mr. Rodgers was not being paid more than a reasonable compensation for his services during the years here involved.

Obviously, the above evidence was sufficient to spel the presumption of correctness in favor of the mmissioner's determination, for as was stated by this urt in Gersteen v. Commissioner, 267 F.2d 195, 199 th Cir. 1959), the presumption disappears "upon the oduction of evidence from which the determination could found inaccurate". Accord, Clark v. Commissioner, 6 F.2d 698, 706 (9th Cir. 1959). With the presumption spelled, the Tax Court was required to render its decision only on the basis of the evidence presented.

To support his determination against the evidence the Petitioner, the Commissioner presented no testimony other evidence, but relied solely on certain stipulated cts which the Commissioner asserted gave the impression at part of the compensation for the years here involved

oked like a disguised dividend. However, when these cts are viewed within the context of this case, as was eviously discussed herein at pages 21 through 27, the ference does not readily follow from these facts. A r more logical explanation appears which in no way dicates either a disguised dividend or unreasonable mpensation.

In view of the Commissioner's failure to present y evidence, or at the most no more than an inference dubious weight, the Tax Court's holding that the Petioner had failed to meet its burden of proof despite the bstantial and significant evidence presented was "clearly roneous".[23] The evidence presented by the petitioner clearly showed the Commissioner's determination to be ong that the decision in the Commissioner's favor was lpably in error. The Tax Court cannot substitute its n innate conception of reasonableness in place of the gnificant and substantial evidence to the contrary.

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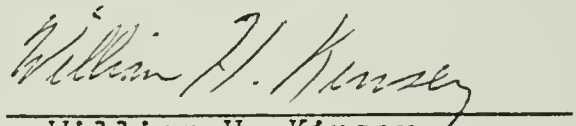
23 Findings of a court are never conclusive d shall be overturned if "clearly erroneous". "A nding is 'clearly erroneous' when although there is idence to support it, the reviewing court on the entire idence is left with the definite and firm conviction at a mistake has been committed." United States v. ited States Gypsum Co., 333 U.S. 364, 394 (1948); ace Bros. v. Commissioner, 173 F.2d 170, 174 (9th r. 1949).

CONCLUSION

For the reasons set forth above, this Court should verse the decision of the Tax Court and allow Petitioner deduction for all the compensation paid to Mr. Rodgers r the fiscal years ended January 31, 1963 and January 31, 64.

Respectfully submitted,

MAUTZ, SOUTHER, SPAULDING,
KINSEY & WILLIAMSON



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CERTIFICATE

I certify that, in connection with the preparation
this brief, I have examined Rules 18 and 19 of The
ited States Court of Appeals for the Ninth Circuit,
d that, in my opinion, the foregoing brief is in full
mpliance with those rules.

William H. Kinsey

William H. Kinsey

Of Attorneys for Appellant

APPENDIX "A"

Direct Examination

of

David Lees

MR. KINSEY: Petitioner will next call Mr. David Lees.

DAVID LEES

was called as a witness on behalf of the petitioner and, having been first duly sworn, testified as follows:

THE CLERK: For the record may we have your name.

THE WITNESS: Dave Lees.

THE CLERK: Your address, please.

THE WITNESS: 4140 Southwest Seventy-fifth, Portland, Oregon.

DIRECT EXAMINATION

BY MR. KINSEY:

Q. What is your occupation, Mr. Lees?

A. I am a grain trader and train carlot trader and also carlot seeds and commodities.

Q. And your business office is here in Portland?

A. That is right.

Q. Are you acquainted with Mr. Rodgers?

A. Yes.

Q. Are you competitors?

A. Yes.

Q. In the trading, I realize you don't have a grain elevator.

A. We are competitors and he is a supplier and also a customer.

Q. Would you say that your operations are comparable?

A. Similar, yes. We don't have any elevator and he has an elevator.

Q. How long have you known Mr. Rodgers?

A. Since about 1949, whenever he came to Oregon, and he was at Monroe, Oregon.

Q. And you were acquainted with him when he was managing Derry Warehouse?

A. Right.

Q. And all through the period that he has been president of Pacific Grains?

A. Right.

Q. Do you think that his worth as a trader is greater now than it was, say, in 1955?

A. Certainly.

Q. '54?

A. Certainly.

Q. How is Mr. Rodgers regarded in the trade, as competent or otherwise?

A. Real competent and he is a good trader and his contracts are good. His integrity is above reproach and he does a lot of business.

Q. Now, you may have heard Mr. Brevig's testimony that the net income of Pacific Grains for 1964 was $90,822, we will say ninety thousand in round figures. Previous testimony indicates that that was attributable to the efforts of Mr. Rodgers as a

trader. For a trader of Mr. Rodgers' capability and if he generated $90,000 of net income, what do you think would be reasonable compensation for the services so rendered?

MR. RANDALL: Your Honor, I would object to that question. I don't think the witness has demonstrated that he is qualified to pass on that.

THE COURT: Sustained. I don't want his opinion. If you have any-- this man operates a comparable business, you can ask him what he is being paid or anything like that but that doesn't qualify the witness as an expert on salaries or qualify him to give an opinion.

BY MR. KINSEY:

Q. May I ask this question. If Mr. Rodgers worked for you and generated $90,000 of net income, what would you consider to be reasonable compensation?

MR. RANDALL: Your Honor, again I object for the same reason.

THE COURT: Sustained. What you can show is what any comparable business actually paid in this community. But what some businessman's opinion is as to what would be a reasonable salary, that is something the court is going to have to find out and determine or would like to determine from what other businesses are actually paying but not from just an opinion by somebody else.

MR. KINSEY: Well, really what I am asking is what he

would hire Mr. Rodgers for if he--

THE COURT (interrupting): Which is just another way of asking for his opinion.

MR. KINSEY: That is correct.

THE COURT: That is just exactly what I say you can't do, ask for his opinion, he isn't qualified as an expert. Experts are the only ones that can give opinions.

MR. KINSEY: Well, don't you think there would be some relevancy to finding out what Mr. Rodgers could get if he quit Pacific Grains and hired out somewhere else?

THE COURT: Well, no, no, that is just another way of asking for an opinion. You brought out the fact that this man's business was comparable, I thought maybe you were going into what that business paid.

MR. KINSEY: Well, he doesn't want to say for the public record what he was making.

THE COURT: I am afraid he can't testify, can he. He can't give us his opinion that way.

MR. KINSEY: Well, then, I guess we have an insurmountable burden of proof in so far as that.

THE COURT: Oh, no, no. In that case you can show what the salary was paid officers of similar corporations doing much the same business. No, it isn't insurmountable. It isn't easy, I will tell you that, but it isn't insurmountable.

MR. KINSEY: As a matter of fact, I think that same

case of yours pointed out that they did not have any evidence of comparable--

THE COURT (interrupting): Oftentimes you don't have and that isn't fatal to your case.

MR. KINSEY: I didn't mean our whole burden, I meant as far as showing what comparable salaries were.

THE COURT: I can't remember what case it is, I did have cases where they did have testimony of comparable business. But it isn't insurmountable. Frequently, you can show it.

BY MR. KINSEY:

Q. May I ask this, you stated that Mr. Rodgers was worth more today than he was back in 1954.

MR. KINSEY: Again this might be opinion, I was going to ask whether he could express that in percentages.

THE COURT: Well, I think it was brought out that Mr. Rodgers--you had a perfect right to bring out his competency and his position and you have brought that out.

MR. KINSEY: I guess I could ask whether his compensation was more or less than Mr. Rodgers.

THE COURT: You have already brought out that he is in a comparable business.

MR. KINSEY: Could we have a little recess?

THE WITNESS: Can I say something?

MR. KINSEY: Yes.

THE WITNESS: I think in our business and independent

trading business that the majority of your good, aggressive traders, their compensation is all about proportionately the same. I know of competitors whose compensation is about the same as Mr. Rodgers. We are a trading organization and everything about us is trading. In other words, if a man does a good job and he asks for more money and we are making more money, why shouldn't he make more money, and we don't work on percentages, we work--if we buy a car of corn and we make $2.50 we trade it.

THE COURT: I think you better confine this to questions and answers.

BY MR. KINSEY:

Q. Would you care to state, Mr. Lees, whether your compensation--

THE COURT (interrupting): First, I would like to know whether or not Mr. Lees' position is comparable in his business to Mr. Rodgers'.

BY MR. KINSEY:

Q. Would you explain--

THE COURT (interrupting): Is it comparable, would you say?

THE WITNESS: You mean in position?

THE COURT: Yes.

THE WITNESS: I own a corporation.

THE COURT: Do you care to tell us what you are

getting?

THE WITNESS: I won't tell you my salary but I would say it is comparable to what Mr. Rodgers gets. It is comparable in percentage of business, gross profit and net profit.

BY MR. KINSEY:

Q. And in dollar amount, too?

A. And dollar amount, I mean in proportion and net profit, it is about the same. This is not unusual.

THE COURT: That is much better than his opinion.

MR. KINSEY: It certainly is.

THE WITNESS: It is not unusual in trading companies.

MR. KINSEY: I just wondered whether you consider you have gained something from that testimony. I think it is quite effective but I just wondered.

THE COURT: I think it is much better than his opinion.

MR. KINSEY: He just said comparable, but I just wondered if you figured that gives you any clue.

THE COURT: That's enough.

MR. KINSEY: All right. Your witness.

CROSS-EXAMINATION

BY MR. RANDALL:

Q. You stated that the compensation was comparable. Do you mean comparable for the years before the court or for the years subsequent. The years before the court are 1963 and 1964. The total salary in 1963 was $41,250, and in 1964 the

APPENDIX "B"

hibit No.	Offered	Identified	Received
A through E	3	3	3